



MIDDLE EAST INSIGHTS

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DEPOSIT INSURANCE IN ISLAMIC BANKING

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Following the global financial crisis many countries introduced or enhanced deposit protection schemes to increase customer confidence in their banking systems. In the Eurozone, for example, bank deposits of up to €100,000 (US\$112,000) are guaranteed. In China, as part of its financial reforms in 2015, deposits of up to CNY500,000 (US\$75,000) are protected by the Peoples Bank. Only a minority of Muslim majority countries have formal deposit protection schemes, Malaysia being the pioneer, with the scheme provided by Perbadanan Insurans Deposit Malaysia (PIDM) covering deposits of up to RM250,000 (US\$61,000); less generous cover than the Chinese scheme. A similar Deposit Insurance Company was established in Indonesia, in 2004, but its cover is worth even less. In the Arab World there is an informal understanding that governments will bail out depositors in the event of a bank collapse, but such guarantees are unlikely to provide much assurance, especially in failed states.

The status of Islamic bank deposits raises additional complications, as risk sharing is a key principle of *Shari'ah* compliant financial transactions. If all risks are transferred from depositors to governments or its agencies this potentially violates the principle. There is the moral issue of whether the fiscal priority in the event of a financial crisis should be to compensate depositors who are more affluent or to aid the poor who usually do not have bank accounts. *Shari'ah* scholars on the boards of Islamic banks distinguish between current account deposits where there is no income and investment accounts based on *mudaraba* contracts where the depositor shares in the bank's profits. Funds in current accounts can be guaranteed, but this does not extend to investment accounts where deposits are regarded as equity. Is such a distinction valid and what are the policy implications?

The Islamic Deposit Insurance Group

There has been little research on deposit protection from an Islamic perspective. The major work was a survey undertaken by the Islamic Deposit Insurance Group of the International Association of Deposit Insurers, a division of the Bank for International Settlement based in Basel, the results of which were published in March 2010.¹ Since then there have been no new initiatives despite the implementation of Basel III and the continuing fragility of emerging markets, including Muslim majority countries adversely affected by oil price declines. The ability of governments in the Islamic World to offer open ended guarantees has clearly been reduced, but should the banks and their clients pay for their own protection?

Profit sharing investment accounts were of particular concern to the Islamic Deposit Insurance Group, with *Shari'ah* scholars arguing that the losses borne by these account holders are inherent in *mudaraba*, which is how the accounts are designated. It can therefore be argued that such depositors should not enjoy protection, as this would imply solely profit sharing and not profit and loss sharing. A contrary view is that profit sharing investment depositors should be protected for the following three reasons:

- (1) Although the profit-sharing contract does not allow an Islamic bank to protect the investment account holder, protection by third parties, such as deposit insurers, is permissible;
- (2) The investment account holder is only protected in the event of an Islamic banking failure and not in the normal course of business;
- (3) If the investment account holders are major players in the financial system, protection will contribute to stability.

These arguments by the Islamic Deposit Insurance Group have merit, but are not entirely convincing. Firstly third party guarantees are more a matter of necessity as failing banks will by definition not have the resources to bail out their depositors. Whoever provides the guarantees there is a risk transfer away from the depositors, undermining the justification for their profit shares. Secondly in the normal course of business there is no risk of loss, the main purpose of protection schemes being to assure depositors that their money will be safe if conditions deteriorate. A more interesting issue is whether the risk appetite of investment depositors remains constant or reduces in downturns with depositors becoming more risk adverse. This is really an empirical matter which can only be addressed by attitude surveys to ascertain the behaviour of investment account depositors. The third point regarding the dangers to the financial system if uninsured Islamic investment depositors are significant players concerns systemic risk. This can only be measured by calculating the share in total deposits of Islamic banks and what proportion of these deposits is accounted for by investment accounts. Even in the countries where Islamic finance is well developed, such as Malaysia and the Gulf, the share of Islamic investment deposits is arguably too small to pose systemic risks.

Discrimination in deposit protection implies there will not be a level playing between Islamic investment deposits and conventional savings accounts. If only the latter are protected this may result in unfair competition to the detriment of those seeking *Shari'ah* compliant services. Discriminatory treatment may disadvantage those with Islamic

¹ Islamic Deposit Insurance Group, *Deposit Insurance from the Shari'ah Perspective*, International Association of Deposit Insurers, Bank for International Settlements, Basel, February 2010.

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investment deposits. If the whole banking system collapses, as was almost the case in the global financial crisis of 2008, it would arguably be unfair for Islamic investment depositors to be bailed in and suffer losses while conventional depositors were bailed out. This would be particularly unjust as Islamic banks did not cause the crisis but rather conventional institutions such as Lehman Brothers which behaved in a highly dubious way from a moral perspective.²

Risks with Restricted and Unrestricted Investment Deposits

There are two categories of investment deposits with Islamic banks: restricted and unrestricted.³ The latter account for by far the largest share of Islamic investment deposits, but the restricted deposits have a long history since they were first offered by Jordan Islamic Bank in the late 1970s. In Jordan the funds placed in restricted accounts are not guaranteed whereas deposits in the unrestricted deposits are guaranteed.⁴ Those clients with restricted accounts are regarded as investors, but those with unrestricted accounts are designated simply as depositors. Those with unrestricted accounts in Jordan are issued with certificates of deposit which can be redeemed at the bank subject to periods of notice. They can also sell the certificates to third parties as is the case with conventional certificates of deposit. This could enable certificate holders to obtain cash without exit penalties there being an incentive to buyers if the expected returns on the certificates are higher than those currently offered by the bank. From the perspective of Jordan Islamic Bank the advantage is that less liquidity is required to fund immediate withdrawals. These product features mean that the unrestricted investment deposit is securitized and tradable, with the possibility of modest capital gains or losses for certificate holders, although these are wiped out if the certificates are held to maturity with the redemption conditions respected.

Usually the returns to restricted Islamic account holders are higher than those of the unrestricted investment accounts as the investment is more focused, but this also results in greater risk which is reflected in higher volatility. As the unrestricted account holders' profits are derived from those of the bank which reflects a broad portfolio of assets this tends to have a smoothing effect. Classifying the unrestricted and restricted accounts for regulatory purposes also has challenges as there are no conventional equivalents.⁵ They could be equated with investments in mutual funds but this might be misleading in the case of unrestricted account holders as the profit shares paid to depositors are usually lower than the dividend pay-outs to equity investors. Furthermore, equity investors can profit from capital gains, but the best case scenario for investment account holders is to have their deposits refunded in full, as if the bank experiences major financial difficulties they face liability for losses.⁶

² Ahmed, Adel, "Global financial crisis: an Islamic finance perspective", *International Journal of Islamic and Middle Eastern Finance and Management*, 3.4 (2010): 306-320.

³ Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance*, Edinburgh University Press, 2012, pp. 45-55.

⁴ <http://www.jordanislamicbank.com/en/?427dacca3edd8203f5aceefbb0637378fc4d0aabc773c0>

⁵ Archer, Simon and Rifaat Ahmed Abdel Karim, "Profit-sharing investment accounts in Islamic banks: regulatory problems and possible solutions", *Journal of Banking Regulation*, 10.4 (2009): 300-306.

⁶ The rights of investment account holders are set out in detail by Jordan Islamic Bank: <http://www.jordanislamicbank.com/en/?427dacca3edd8203f5aceefbb3637b78fc4d0aabc776c3>

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The risks for the restricted investment account holders depends on how this type of deposit is structured. If the bank is simply serving as an agent, connecting the investor with the business seeking funding, then arguably the *mudarabah* contract is between the client and the user of the funds. In the event of the bank being liquidated there would be no claim on the restricted account holder, as their liability would only be to the business using the funds.⁷ Indeed, if the bank as agent failed to provide accurate information to the restricted investment account holder on the business being funded, the account holder could litigate against the bank claiming negligence or perhaps even alleging that they had been deliberately misled. If the restricted investment account is structured as a two-tier *mudarabah*, then the depositor has a liability if the bank is liquidated but not for the bankruptcy of a business using the funds, as in this instance the liability is borne by the bank only. Given these risk factors it is unsurprising that the two tier *mudarabah* model favoured by the early supporters of Islamic finance in the 1970s has never taken-off.⁸

Consequences of Loss Sharing

While *Shari'ah* scholars insist that *mudaraba* implies profit and loss sharing and not simply the former, how to apply this principle is debatable. With multiple stakeholder groups involved in modern Islamic banking, there is the issue of pecking orders and who bears what losses. For example, if the bank is making losses because its administrative costs have risen significantly, reducing the workforce or cutting salaries may be more appropriate than penalising depositors in order to resolve the underlying problem. Similarly, if the losses are arising because of the need to make provisions for non-performing debt, possibly at the insistence of the regulator, then it is hardly just to shift the burden to investment depositors. In any case only restructuring can address the problem, simply imposing losses on investment depositors can at best only postpone the measures needed. Furthermore, in normal circumstances when banks get into difficulties it is the shareholders who absorb the losses as the share prices decline, not the depositors. The shareholders as owners are expected to primarily bear the losses, followed by holders of junior debt, such as bonds which get bailed in, a process known as having a haircut. It would arguably be unfair for depositors to be forced to absorb losses in order to reduce the liabilities of these other stakeholders who are higher up the pecking order of those accountable for losses.

These issues would not arise if the Islamic financial institution adopted a pure *mudaraba* model, with no shareholders and no current account depositors. Investors as *rabb-al-mal* would share the profits from the projects they funded, with the financial institution also earning a profit share as *mudarab*, this being justified by its role in project appraisal and selection and its subsequent managerial role in administering the payments. Such an institution would be an investment trust, but not a bank, as there would be no liquid accounts that could be used for payments. An Islamic investment trust would be able to take on more risk, as with no depositors it would not require central bank regulation. It is noteworthy that in Pakistan such institutions are not regulated by the State Bank, but rather function under a special company law.⁹

⁷ Djojosegito, Reza, "Mitigating legal risk in Islamic banking operations", *Humanomics*, 24.2 (2008): 110-121.

⁸ Anwar, Muhammad, "Islamicity of banking and modes of Islamic banking", *Arab Law Quarterly*, 18.1 (2003): 62-80.

⁹ Rehman, Wasim Ul, et al. "Intellectual capital performance and its impact on corporate performance: empirical evidence from the *modaraba* sector of Pakistan", *Australian Journal of Business and Management Research*, 1.5 (2011): 8-16.

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In Malaysia the Islamic Financial Services Act of 2013 specifies that investment accounts should be subject to both profit and loss sharing, as hitherto holders of such accounts in practice only shared profits.¹⁰ As a consequence of the legislation leading Islamic banks have revised the terms and conditions of their investment accounts to be in compliance with the new law. In the case of Maybank Islamic, the leading Islamic bank in Malaysia and the third largest in the world, more than 350,000 customers with *mudaraba* deposits had to be contacted to provide consent for their accounts to be converted to profit and loss sharing.¹¹ Those unhappy with this change of terms and conditions were offered other types of account. Most kept their accounts as the returns offered were relatively generous with 3.25 percent paid annually on the accounts of minors and 4 percent offered on term accounts.

Loss sharing by investment account holders has yet to be tested, as it remains unclear exactly when a depositor liability might arise. Is it only in the event of an Islamic financial institution becoming insolvent that the investment depositors have to share in the losses? If losses are incurred but the bank remains solvent it is more problematic to argue for deposits being written down. In such circumstances depositors may not be paid a profit share, as there are no profits, hence their deposits will have more of the characteristics of current accounts. The underlying issue is that deposit guarantees bring certainty, but if these are prohibited for investment account holders – the inevitable consequence is greater uncertainty.

Islamic deposit insurance schemes

In response to these uncertainties there has been debate about the merits of establishing specialist Islamic deposit insurance schemes.¹² The aim of such schemes is to prevent depositors from experiencing financial difficulties, increase the confidence of investment account holders about the safety of their deposits, ensure the stability of Islamic financial systems and maintain the competitiveness of Islamic deposits. These aims could arguably be served by a conventional deposit insurance institution, but such institutions hold assets such as bonds which earn interest and are therefore not *Shari'ah* compliant. There are also issues of conflict of interest between the stakeholders in conventional insurance schemes, which can be overcome by providing *takaful*.¹³

In Malaysia both Islamic and conventional bank deposits were protected by Perbadanan Insurans Deposit Malaysia (PIDM), a government agency established in 2005 which was overseen by Bank Negara, the Central Bank.¹⁴ Following the Islamic Financial Services Act of 2013 the insurance for Islamic deposits was separated with the new protection contracts based on the concept of *kafalah* (guarantee) and *tabarru'* (donation). In line with these principles, the relevant member institutions make donations to the Malaysia Deposit Insurance Corporation (PIDM) which then provides depositors with insurance coverage and ensures pay-outs in the event of bank failure. Islamic deposits are

¹⁰ Law of Malaysia, Act 759.

¹¹ Media Release, "Maybank's *mudarabah* investment accounts to provide potentially higher and stable returns", Kuala Lumpur, 22nd April 2015.

¹² Md Khairuddin Hj Arshad, *Implementation of an Islamic Deposit Insurance System for the Islamic Financial Services Industry*, Islamic Financial Services Board, Kuala Lumpur, 17th November 2011.

¹³ Wahab, Abdul Rahim Abdul, Mervyn K. Lewis, and M. Kabir Hassan, "Islamic *takaful*: business models, *Shari'ah* concerns and proposed solutions", *Thunderbird International Business Review*, 49.3 (2007): 371-396.

¹⁴ <http://www.pidm.gov.my/Home.aspx>

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covered separately from conventional deposits up to an amount of RM250,000 per depositor per member institution. Islamic deposits eligible for coverage include savings and investment deposits, both *mudaraba* and *non-mudaraba*, but exclude deposits payable outside Malaysia, foreign currency deposits, negotiable instruments of deposit, other bearer deposits and repurchase agreements, as is the case for conventional deposits.¹⁵

Conclusions

Whether these changes are semantic or substantive is debatable, as they raise the issue of form versus substance which is prevalent in many areas of contemporary Islamic finance. Investment account protection insurance is compulsory in Malaysia, the costs being covered by the Islamic banks on behalf of their clients. As insurance is provided by a third party, PIDM, it is argued that this does not violate the profit and loss sharing *mudaraba* contracts between the banks and their clients. Furthermore the PIDM protection is only triggered in the event of bank failure, and not in the normal course of business which involves profits and losses. However the latter are not shared either, the worst case scenario for the client being no profit share payment. The exclusion of loss sharing is of course a win-win situation for the client that they are unlikely to complain about. In reality they have a profit sharing contract, which admittedly provides rate of return risk sharing, but not liability to losses which might be one risk too far. The best that might be said is that the debate about protection for Islamic deposits has increased awareness of the issues, but has not provided solutions that will satisfy everyone.

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¹⁵ Rebecca Simmonds, "Impact of the implementation of the Islamic Financial Service Act, 2013", *Islamic Finance News*, 11.14, 9th April 2014.